

The PERAC Financial Bulletin

Financial Market Review, First Quarter 2006



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a.
promising
start



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Despite a lack of conviction on the part of many investors, the stock market quietly enjoyed one of its best quarters in years. There was concern over rising interest rates and the market appeared to be trendless for much of the quarter, but the S&P 500 (+4.2%) had its best first quarter since 1999, the NASDAQ Composite (+6.1%) had its best quarterly start since 2000, and the Russell 2000 small cap index (+13.9%) confounded conventional wisdom by continuing to significantly outperform large caps.

Long-term interest rates reached their highest levels in two years, while gold continued to rise and oil refused to fall. On the other hand, optimists held out hope that the Fed's continued tightening would eventually result in a "Goldilocks" economy where growth, interest rates, and inflation were all just right.

There was little differential between

growth and value stocks but, despite having already registered six years of substantial outperformance, small caps trounced large caps by almost 10% during the quarter. The annualized return of the Russell 2000 has exceeded that of the S&P 500 by over 12% over the trailing three years and by almost 9% over five years. The Russell 2000 continues to reach new record highs while the S&P 500 remains 18% from its record high.

Energy stocks continued to do well, but it remained a stock pickers market. Reflecting the divergence in returns, Caterpillar was up 24.3% while Intel was down 22.5%.

Also continuing a longstanding trend, international stocks outperformed the US markets as the MSCI-EAFE index rose 9.4%. Over the trailing three years, this index was up an annualized 31.1%, trouncing the S&P 500 (+17.2%) by almost 14% a year. Emerging markets remained on a roll,

as the MSCI-EM Index rose 12.0%. Strength was widespread in world markets during the quarter, but, in particular, markets in Mexico, India, and Australia reached historic highs.

Stocks decisively outperformed bonds during the quarter as the Lehman Aggregate Index recorded a loss of -0.65%. After the Federal Reserve's 15th consecutive rate increase, the Federal Funds rate was at 4.75%, up from its recent 45-year low of 1%. The benchmark 10-year Treasury note rose in yield from 4.39% to 4.86% during the quarter. (Rising rates mean lower market values for existing bonds.) The corporate bond market performed well, as yield differentials to Treasury bonds remained historically narrow. Reflecting fears over a possible bankruptcy by General Motors, the high yield "junk bond" market was more unsettled but still remained stable overall.

The yield curve remained slightly

Chart 1

S&P 500, 12 Months: A Rising Trend

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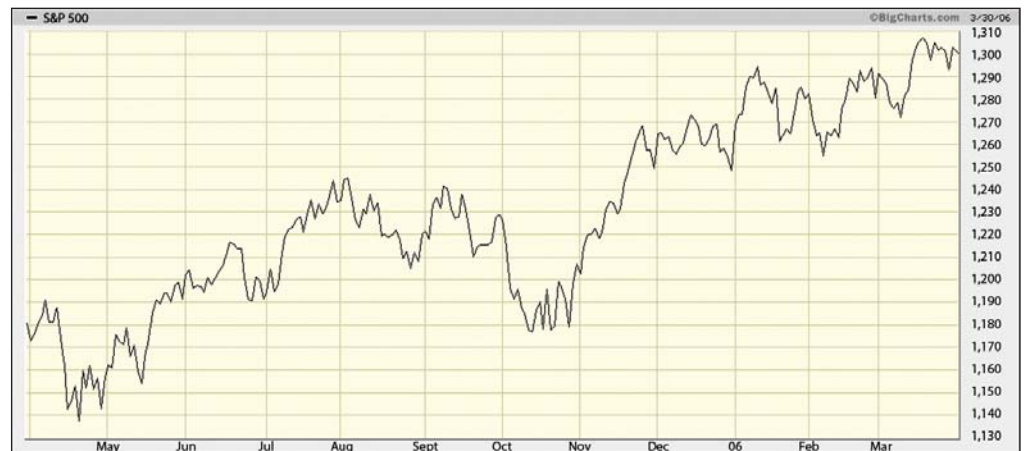
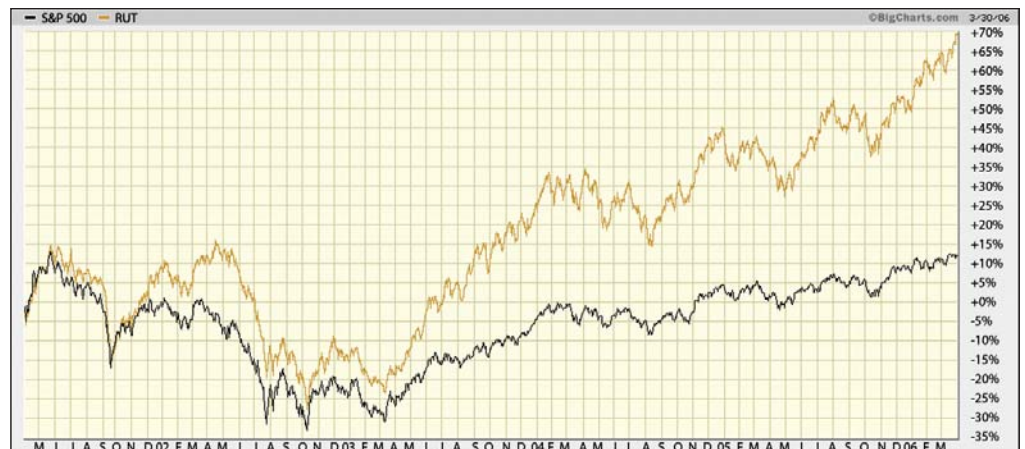


Chart 2

S&P 500 vs Russell 2000: Over Five Years, Small Caps Rule

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inverted (meaning that short maturity bonds yielded more than longer bonds) at times, but new Fed Chairman Bernanke joined those who have downplayed the significance of this unusual occurrence. He also signaled that, contrary to the hopes of stock investors, further tightening is likely. Adding to investor unease was that, for the first time in several years, interest rates in Europe and Japan were also headed higher.

Returns from private equity and venture capital are reported with a significant lag, but one measure of those markets' health—the Initial Public Offerings market—appeared to be languishing. Both the number of venture-backed IPOs and the average size of issuance declined from the last quarter of 2002. Both the average and median sums raised were the lowest since the third quarter of 2002.

While residential real estate has softened throughout the country,

commercial real estate continued to provide healthy returns. Despite predictions that an end to their long run of strong performance was likely, publicly-traded real estate investment trusts returned a surprising 14.7% for the quarter. This sector's annualized return for the trailing three-year period is 32.1%. The first quarter return of the NCREIF Index of private apartments, hotels, industrial, office, and retail real estate is not yet available, but results for the year 2005 indicated a strong return of 20%.

Hedge funds appeared to be beginning 2006 in a quiet and unspectacular manner. With returns restrained by low volatility in the stock market and weakness in the bond market, early indications of first quarter composite performance (spanning the wide range of distinct hedge fund strategies) were in the range of +2 to 4%.

There's no telling which asset classes will prove to be the best performers

over the course of the year, but the results of the first quarter confirm once again the benefits of diversification both within equities (having small and mid-caps as well as large caps) and in other asset classes such as international equities and real estate. As always, boards must be vigilant to ensure that poorly performing managers are not offsetting the advantages of good asset allocation. As always, the PERAC Investment Unit is available to offer advice or assistance of any kind to help retirement systems achieve their investment goals.

Chart 3

S&P 500: Ten Year Perspective

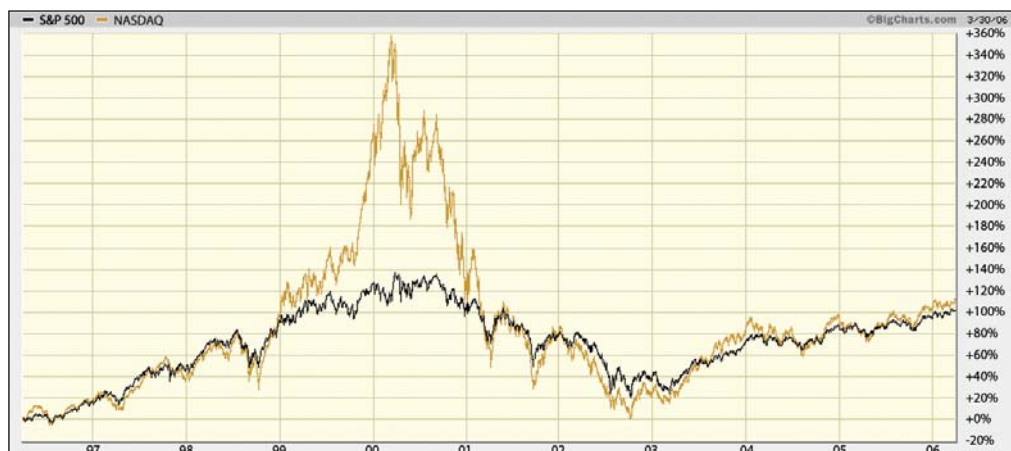
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Chart 4

S&P 500 vs NASDAQ, Ten Years: Except for the Bubble, About Even

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TOTAL RETURNS | FIRST QUARTER, 2006

INDEX	FIRST QUARTER 2006	TRAILING TWELVE MONTHS
US EQUITY MARKET		
Dow Jones Industrial Avg.	+ 4.25%	+ 8.27%
Standard & Poor's 500 (Large Cap)	+ 4.21%	+ 11.73%
NASDAQ Composite	+ 6.20%	+ 14.90%
Wilshire 5000 (Broad Market)	+ 5.54%	+ 14.96%
Standard & Poor's Mid-Cap 400	+ 7.63%	+ 21.62%
Russell 2000 (Small Cap.)	+ 13.94%	+ 25.88%
GROWTH VS. VALUE		
Russell 1000 (Large Cap) Growth	+ 3.09%	+ 13.14%
Russell 1000 (Large Cap) Value	+ 5.93%	+ 13.31%
Russell Midcap Growth	+ 7.61%	+ 22.68%
Russell Midcap Value	+ 7.62%	+ 20.30%
Russell 2000 Growth	+ 14.36%	+ 27.84%
Russell 2000 Value	+ 13.51%	+ 23.77%
INTERNATIONAL EQUITY		
M.S.C.I. - E.A.F.E.	+ 9.40%	+ 24.41%
M.S.C.I. - Emerging Markets	+ 12.02%	+ 73.63%
FIXED INCOME		
Lehman Brothers Aggregate Index	- 0.65%	+ 2.26%
Merrill Lynch High Yield Index	+ 2.87%	+ 7.23%
REAL ESTATE		
NAREIT - Equity Real Estate Investment Trusts	+ 14.74%	+ 38.46%
NCREIF Property Index	+ 5.43%	+ 20.06%
	(Q4)	(Trailing 12 months)